Supreme Court, U.S.
FILED
JUL 15 1991
OFFICE OF THE CLERK

No. 90-1918

In The

Supreme Court of the United States

October Term, 1991

KRAFT GENERAL FOODS, INC.
(formerly KRAFT, INC.),

Petitioner,

vs.

IOWA DEPARTMENT OF REVENUE AND FINANCE,

Respondent.

Petition For Writ Of Certiorari To The Supreme Court Of Iowa

RESPONDENT'S BRIEF IN OPPOSITION

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QUESTIONS PRESENTED FOR REVIEW

1. Whether the Iowa Business Tax on Corporations, which includes foreign subsidiary dividends in the tax base while excluding domestic subsidiary dividends from its base, is valid under the Commerce Clause because it does not advantage Iowa activity at the expense of non-Iowa activities and is justified by valid factors not related to economic protectionism.

2. Whether Iowa's treatment of dividends for the Iowa Business Tax on Corporations is valid under the Equal Protection Clause because it is rationally related to legitimate state purposes.

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STATEMENT OF THE CASE

The Respondent, Iowa Department of Revenue and Finance (Department), accepts Petitioner's statement of the case as substantially correct, but the following additional facts should be noted.

During the year 1981, the Internal Revenue Code permitted a domestic corporation which received dividends from foreign corporations to claim a federal income tax credit for a portion of the income and certain other taxes paid by the dividend payors to foreign governments and for a portion of any foreign income taxes paid by the dividend payee with respect to the dividend. Alternatively, the dividend payee was allowed to claim as a deduction on its federal income tax return the foreign income taxes withheld with respect to the dividends it received from foreign corporations. (App. 31a, Petition for Writ of Certiorari).

If a taxpayer elected to deduct foreign taxes to determine federal taxable income, it would also deduct such taxes to calculate Iowa Code § 422.35 net income. Section 422.35 defined "net income" as the taxable income before the net operating loss deduction as properly computed for federal income tax purposes under the Internal Revenue Code, with certain adjustments, none of which are relevant to this case. (App. 32a, Petition for Writ of Certiorari).

In the District Court, the only prongs of the Commerce Clause test argued by Kraft were the discrimination against foreign commerce and multiple taxation

prongs. Kraft abandoned the issue of an alleged unconstitutional interference by Iowa with United States foreign policy.

The District Court, in addition to what is noted in Kraft's Statement, found that Kraft had "not shown that the Iowa tax exerts a pressure on interstate business to conduct more of its activities in Iowa." (App. 17a, Petition for Writ of Certiorari).

In the Iowa Supreme Court, Kraft abandoned the multiple taxation question. The only Commerce Clause issue presented to the Iowa Supreme Court was whether the Iowa corporate income tax structure unconstitutionally discriminates against foreign commerce. (App. 5a, Petition for Writ of Certiorari). The Iowa Supreme Court held that there was no unconstitutional discrimination against foreign commerce because there was no showing "that Iowa businesses receive a commercial advantage over foreign commerce due to Iowa's taxing scheme." (App. 7a, Petition for Writ of Certiorari).

Dividends, whether declared by a domestic subsidiary or a foreign subsidiary, are declared and payable from the earnings of the subsidiary. (App. 41a, Petition for Writ of Certiorari).

The foreign subsidiaries which paid the dividends involved in this case were part of Kraft's unitary business, a portion of which was conducted in Iowa. (App. 33a, Petition for Writ of Certiorari). The foreign subsidiary dividends, therefore, constituted a portion of Kraft's apportionable unitary business income. (App. 33a, Petition for Writ of Certiorari).

SUMMARY OF THE ARGUMENT

The only prong of the Commerce Clause test at issue in this case is the discrimination prong. Including foreign subsidiary dividends in the apportionable income for the Iowa Business Tax on Corporations, while excluding domestic subsidiary dividends, does not violate the Commerce Clause by unconstitutionally discriminating against foreign commerce. It does not favor any Iowa activity at the expense of non-Iowa activities. It does not provide a commercial advantage to local business, encourage the diverting of new business to Iowa or operate as a disincentive for existing instate business to move elsewhere. As a unitary business' Iowa activities increase, more of its unitary earnings will be included in Iowa net income. Therefore, out-of-state commerce is actually favored at the expense of local commerce. The Iowa tax system does not discourage the incorporation of foreign subsidiaries. If every state adopted the Iowa unitary taxation method, the unitary earnings of domestic subsidiaries could be subject to greater tax than would be the foreign subsidiary earnings. A unitary business is not taxed more harshly by Iowa if it is engaged in foreign commerce than if it is engaged in interstate or intrastate commerce.

The difference in Iowa's treatment of foreign and domestic dividends is a byproduct of Iowa's decision to use the federal taxable income figure as the starting point for computing Iowa net income. Use of the federal taxable income figure results in benefits to taxpayers and the State. Therefore, the Iowa tax treatment of dividends is justified by a valid factor unrelated to economic protectionism.

Coupling Iowa's tax base to federal taxable income serves legitimate state purposes. Because Iowa's treatment of dividends is a byproduct of that coupling, it is rationally related to legitimate state purposes. Therefore, it does not violate the Equal Protection Clause.

REASONS TO DENY THE PETITION

I. IOWA'S TREATMENT OF DIVIDENDS DOES NOT UNCONSTITUTIONALLY DISCRIMINATE AGAINST FOREIGN COMMERCE.

Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977), articulates a four-prong test to evaluate whether a state tax violates the Commerce Clause with respect to state taxation of interstate commerce. A state tax will be sustained "against Commerce Clause challenge when the tax is [1] applied to an activity with a substantial nexus with the taxing state, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State." 430 U.S. at 279. In the event that the state tax is imposed upon foreign commerce, rather than interstate commerce, the test includes the four prongs in *Complete Auto* and, in addition, the considerations of "the enhanced risk of multiple taxation" and whether the state tax "prevents the Federal Government from speaking with one voice" in foreign affairs. *Container Corporation v. Franchise Tax Board*, 463 U.S. 159, 185, 193 (1983); *see Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 446, 448 (1979).

Of the above six prongs, Kraft has confined its argument to a consideration of only one. This is the discrimination prong. (App. 5a, Petition for Writ of Certiorari).

Kraft contends that Iowa's tax system discriminates illegally against foreign commerce. All of the remaining prongs are not at issue and Iowa's tax laws must be presumed not to violate them. If the Court believes it is necessary to review a case involving different treatment of dividends depending on whether they are paid by a foreign or domestic subsidiary, a better case for review would be one where more of the six prongs of the test are before the Court for consideration.

Kraft states that the "question to be resolved is whether a state taxing scheme that facially discriminates against foreign commerce must be shown to favor *intrastate commerce*, rather than *domestic commerce* generally, in order to be held unconstitutional." (Kraft Pet. at 9). Kraft further states that the "Iowa courts concluded that a showing of discrimination in favor of *intrastate commerce* was required before a state tax on foreign commerce could be considered unconstitutional under the Foreign Commerce Clause." (Kraft Pet. at 9). Kraft has mischaracterized the question to be resolved and the Iowa Supreme Court's decision. The Iowa Supreme Court held that in order to show unconstitutional discrimination against foreign commerce, Kraft must show "that Iowa businesses receive a commercial advantage over foreign commerce due to Iowa's taxing scheme." (App. 7a, Petition for Writ of Certiorari). If Iowa businesses received a commercial advantage, the Iowa Court would have found the Iowa taxing scheme unconstitutional even if those Iowa businesses were engaged in interstate and/or foreign commerce, as opposed to intrastate commerce. The key to the Iowa Court's decision was that no local Iowa activity was advantaged (whether that activity was part

of intrastate, interstate, or foreign commerce) over non-Iowa activities.

A. The Iowa Tax Structure Does Not Violate The Discrimination Prong Because It Does Not Advantage Any Local Iowa Activity At The Expense Of Non-Iowa Activities Or Otherwise Violate The Purposes Of The Commerce Clause.

The Commerce Clause was a dominant theme at the Constitutional Convention called for the purpose of drafting the United States Constitution. In *Wardair Canada v. Florida Department of Revenue*, 477 U.S. 1, 7 (1986), this Court stated:

> As we have previously observed: "The few simple words of the Commerce Clause . . . reflected a central concern of the Framers that was an immediate reason for calling the Constitutional Convention: the conviction that in order to succeed, the new Union would have to avoid the tendencies toward economic Balkanization that had plagued relations among the Colonies and later among the States under the Articles of Confederation."

The vice of the "economic balkanization" affecting economic relations between the states was discrimination against commerce which crossed state lines. Therefore, the Commerce Clause was intended to prevent discrimination against such commerce "providing a direct commercial advantage to local business." *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 268 (1984); *Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318, 329 (1977). State tax schemes which tend to encourage the diverting of new business to the taxing state or operate as a disincentive

for existing instate business to move elsewhere are discriminatory under the Commerce Clause in that they foreclose "tax-neutral" decisions by creating an advantage for instate business. *Westinghouse Electric Corporation v. Tully*, 466 U.S. 388, 406 (1984).

In each Supreme Court case relied upon by Kraft in support of its Commerce Clause discrimination argument, the state taxing scheme favored some instate activity over an activity performed partly or wholly outside the taxing state. In those cases, the state taxing scheme engaged in the very economic balkanization which the Commerce Clause was intended to avoid. "A tax is generally said by the Court to be discriminatory when the taxing State provides a commercial advantage to local business at the expense of out-of-state business." P. Hartman, *Federal Limitations on State and Local Taxation* § 2:19, at 50 (Supp. 1990).

State taxes are discriminatory under the Commerce Clause if instate activities are treated more favorably at the expense of similar activities which cross state lines or where the discrimination interferes with economic decision-making by encouraging the conduct of activities in the taxing state. Tatarowicz and Mims-Velarde, *An Analytical Approach to State Tax Discrimination Under the Commerce Clause*, 39 Vand. L. Rev. 879, 898 (May 1986). Iowa's inclusion of unitary foreign subsidiary dividends in the preapportioned net income base and exclusion of domestic subsidiary dividends from that base does neither. The Iowa tax structure does not encourage, protect, or otherwise advantage instate activities at the expense of out-of-state activities. Indeed, the opposite is generally true. The following examples will illustrate these points.

Dividends payable to Kraft or any other parent corporation are paid from the subsidiary's earnings. (App. 41a, Petition for Writ of Certiorari). The unitary subsidiary, whether foreign or domestic, is merely an extension of the parent corporation's overall unitary business. *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983); *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980); (App. 30a par. 10, Petition for Writ of Certiorari). As will be shown, as a unitary business' Iowa activities increase, more of the unitary earnings will be included in Iowa net income, resulting in greater taxation of those earnings.[1]

Assume that the parent corporation, A, and its wholly owned domestic subsidiary, B, have a unitary relationship and do all of their business in Iowa. Here, all of the earnings of the unitary business will be subject to Iowa taxation, even though none of the dividends declared by B would, under Iowa Code § 422.35, be taxable to A. Under this greatest exposure of the unitary earnings to Iowa, the result is taxation of 100 percent of those earnings, albeit there are two different taxpayers, namely, A and B. If A had a wholly owned unitary foreign subsidiary, C, located solely in a foreign country,

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[1] "It is not a purpose of the Commerce Clause to protect state residents from their own state taxes." *Goldberg v. Sweet*, 488 U.S. 252, 266 (1989). Likewise, the Commerce Clause "is not designed to protect local commerce." Tatarowicz and Mims-Velarde, *An Analytical Approach to State Tax Discrimination Under the Commerce Clause*, 39 Vand. L. Rev. 879, 926 (May 1986).

Iowa would only tax a portion of C's earnings as represented by dividends declared and paid to A. If A dissolved B and incorporated B under the laws of a foreign country to only engage in business activities in that foreign country, Iowa would tax A on a portion of the unitary foreign earnings as represented by the dividends declared by B, but such tax is obviously less than the tax upon 100 percent of B's earnings that occurred when B was wholly located in Iowa. Under the circumstances in this example, there is no discrimination that the Commerce Clause was designed to alleviate, because there is no commercial advantage to local business at the expense of non-Iowa business. Indeed, non-Iowa business is advantaged over local Iowa business under the Iowa unitary business tax structure.

Assume that parent corporation D does all of its business in Iowa and that it has two wholly owned unitary subsidiaries, E and F. Assume that E is a domestic subsidiary and F is a foreign subsidiary located wholly in a foreign country. Assume that E does a portion of its business in Iowa and a portion outside of Iowa. Assume E and F pay dividends to D. Here, again, more earnings of D and E, which have income producing activities in Iowa, than earnings of F, which has no Iowa activities, are included in the preapportioned net income bases of D and E. In this example, D's earnings are fully taxed to D by Iowa. E's earnings are partly taxed to E by Iowa, but are fully in E's preapportioned net income base. The dividends declared by F are in D's tax base, but the dividends do not represent all of F's earnings. Thus, because of D's and E's Iowa activities, a greater portion of their earnings are capable of being taxed by Iowa than F's

earnings. As in the prior example, there is no tax advantage for in-state activities at the expense of out-of-state activities.

Assume that parent corporation G does business partly within and partly without Iowa. Assume that G has a wholly owned unitary foreign subsidiary, H, located entirely in a foreign country and obtains dividends from H. Under these circumstances, G's preapportioned net income base includes G's operating income and the dividends declared by H. Assume that parent corporation I, like G, does business partly within and partly without Iowa. Assume that I has a wholly owned unitary domestic subsidiary, J, which does no business in Iowa. The dividends declared by J are not in I's preapportioned net income base under § 422.35 and, thus, are not included in the determination of I's income attributable to Iowa. (App. 33a par. 21, Petition for Writ of Certiorari). Yet, here again, instate Iowa activities are not encouraged, protected, or otherwise advantaged in comparison to non-Iowa activities. The difference in treatment of the dividends declared by H and those declared by J, and the corresponding difference in treatment of the unitary businesses of G and I are unrelated to any local Iowa activity. The treatment of dividends does not encourage G or I to locate either H's or J's activities in Iowa. The opposite is true, because if either H or J was located in Iowa, Iowa's tax on the unitary earnings would likely increase. There is no economic balkanization, adverse to the Commerce Clause, in this example. There is no direct commercial advantage to local Iowa business at the expense of non-Iowa business.

> The commerce clause may be viewed as a protection from local biases against either interstate or foreign commerce. Thus, it can be concluded that not only negative effects on protected commerce, but also positive effects on local commerce are necessary to find a statute unconstitutional under the commerce clause.

Tatarowicz and Mims-Velarde, *An Analytical Approach to State Tax Discrimination Under the Commerce Clause*, 39 Vand. L. Rev. 879, 941 (May 1986). Because the Iowa treatment of dividends, within the context of its treatment of unitary earnings, does not favor Iowa activities over those which cross state lines and does not encourage or protect the conduct of activities in Iowa, the Iowa tax structure does not discriminate against foreign commerce in violation of the Commerce Clause. While state taxes which discriminate against interstate or foreign commerce to benefit instate activities are invalid, "state taxes which favor out-of-state commerce at the expense of local commerce are not similarly suspect." L. Tribe, *American Constitutional Law* § 6-16, at 354-55 (1978).

Kraft relies heavily upon *Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318 (1977). In that case, a New York stock transfer tax scheme discriminated between different types of interstate commerce. The Supreme Court expressly considered "the question whether a State may tax in a manner that discriminates between two types of interstate transactions *in order to favor local commercial interests* over out-of-state businesses." 429 U.S. at 335 (emphasis added). If the favoring of local commercial interests was not a critical factor, the Court would have had no reason to mention it. Because no Iowa "commercial interests" are favored by the Iowa

treatment of unitary earnings, including dividends, *Boston Stock Exchange* is not supportive of Kraft's position.

Kraft relies upon *Hale v. Bimco Trading, Inc.*, 306 U.S. 375 (1939), which invalidated a Florida law providing for an inspection fee for foreign cement but not for cement produced in the United States. In *Bimco Trading*, however, the Court emphasized that local Florida-produced cement was being protected from competition by foreign-produced cement. It was because of this local instate bias that the law was invalidated.

Kraft relies upon *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979), in which a California property tax was invalidated as applied to shipping containers of a Japanese taxpayer whose home port was in Japan and whose containers were fully taxed there. The Supreme Court noted that if the *Complete Auto* four-prong test applied, the "Commerce Clause inquiry would be at an end." 441 U.S. at 445. The Court noted that when the state tax involves foreign commerce, "two additional considerations, beyond those articulated in Complete Auto, come into play." 441 U.S. at 446. These are, first, "the enhanced risk of multiple taxation" and, second, the impairing of "federal uniformity in an area where federal uniformity is essential." 441 U.S. at 446, 448. But, these "considerations" are not before this Court, because Kraft's constitutional attack is confined to the discrimination prong of *Complete Auto*. As the Iowa Supreme Court recognized, "*Japan Line, Ltd.* did not involve discrimination against foreign commerce, which is the basis of Kraft's commerce clause argument." (App. 7a, Petition for Writ of Certiorari). In the appropriate case, this Court may want to analyze a tax that has no instate biases using

the two additional factors set forth in *Japan Line*. This is not such a case, because Kraft has waived any challenge to the Iowa tax based on those factors.

Cook v. Commonwealth of Pennsylvania, 97 U.S. 566 (1878), discussed by Kraft, does not support Kraft's argument. In *Cook*, a Pennsylvania tax was imposed on sales by auctioneers, with an exception for "groceries, goods, wares and merchandise of American growth or manufacture." *Id.* at 569. Obviously, goods made or grown in Pennsylvania were exempted from the tax, because Pennsylvania is part of America. The tax exemption favored Pennsylvania enterprises at the expense of foreign businesses. The Court stated that, by way of the Commerce Clause,

> the framers of the Constitution believed that they had sufficiently guarded against the dangers of any taxation by the States which would interfere with the freest interchange of commodities among the people of the different States, and by the people of the States with citizens and subjects of foreign governments.

Id. at 574. The Iowa treatment of dividends does not interfere with the free interchange of commodities among people of different states or by Americans with citizens and subjects of foreign governments.

The state court cases relied upon by Kraft are unpersuasive with respect to the discrimination issue. Kraft relies upon *Miller v. Publicker Industries, Inc.*, 457 So. 2d 1374 (Fla. 1984). In *Publicker*, a tax exemption which was limited to gasohol containing ethyl alcohol distilled from United States agricultural products or byproducts violated the Import-Export Clause and the Commerce

Clause. The Florida Court's Commerce Clause discussion is contained in a single paragraph, and no mention is made of whether invalid Commerce Clause discrimination should be analyzed in terms of a local instate bias. Because the tax favored local Florida agricultural products over foreign agricultural products, *Miller* did contain a local instate bias, unlike the situation in the instant case.

Kraft relies on the California cases of *Zee Toys, Inc. v. County of Los Angeles*, 85 Cal. App. 3d 763, 149 Cal. Rptr. 750 (1978), *aff'd by an equally divided Court, sub nom. Sears, Roebuck and Co. v. County of Los Angeles*, 449 U.S. 1119 (1981), and *Star-Kist Foods, Inc. v. County of Los Angeles*, 227 Cal. Rptr. 391, 42 Cal. 3d 1, 719 P.2d 987 (1986), *cert. denied*, 480 U.S. 930 (1987). Those cases involved an exemption from an ad valorem property tax for business inventories of foreign origin or destination which were transshipped through the state. In *Container Corporation v. Franchise Tax Bd.*, 463 U.S. 159, 188-89 (1983), the distinction between a tax on income and a tax on property was one of three distinctions adding up to a "constitutionally significant difference" between the *Container* and *Japan Line* cases. Also, the California property tax exemption gave foreign goods a "competitive advantage over interstate goods of the same nature and competing in the same market." *Zee Toys*, 149 Cal. Rptr. at 757. The Iowa income tax treatment of dividends, including unitary foreign dividends in the apportionable tax base but not unitary domestic dividends, does not favor any Iowa or other states' goods over foreign goods. Another distinction is that the California Courts were concerned that the California exemption statute at issue in *Zee Toys* and *Star-Kist*

might interfere with federally imposed tariffs designed to protect United States manufactured goods threatened by foreign competition. *Zee Toys*, 149 Cal. Rptr. at 757-58; *Star-Kist*, 719 P.2d at 995. No such concern can exist in this case. Finally, although the California Courts purported to rely on *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318 (1977), they apparently did not give sufficient weight to the *Boston Stock Exchange* language that discrimination between two types of interstate transactions is not allowed when done "in order to favor local commercial interests." *Boston Stock Exchange*, 429 U.S. at 335.[2]

Kraft asserts that the Iowa taxing scheme "clearly favors corporations that conduct their unitary business operations through domestic subsidiaries." (Kraft Pet. at 15). This is pure speculation. It has not been demonstrated that the tax burden upon domestic unitary earnings is less than upon foreign earnings.[3] There is no basis

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[2] The dissent in *Star-Kist* recognized that

> [u]nlike *Boston Stock Exchange, Westinghouse Electric,* and *Maryland v. Louisiana,* supra, no burden was imposed on interstate commerce by placing a penalty or disincentive on the choice to transact business in another state. Moreover, unlike the paradigm commerce clause case, local interests are not favored. (See *Westinghouse Electric,* supra, 466 U.S. at p. 403, 104 S.Ct. at p. 1865.)

Star-Kist, 719 P.2d at 1001.

[3] While it is true that foreign subsidiary dividends are in the preapportioned net income base of corporations doing business in Iowa and domestic subsidiary dividends are not

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for assuming that a unitary business engaged in foreign commerce is taxed more harshly than is one engaged in interstate commerce. If every state adopted the Iowa unitary taxation method, the unitary earnings of domestic subsidiaries would be subject to state and United States taxation which could be more burdensome than the taxation of the foreign subsidiary earnings. This possibility negates any claim that the Iowa tax system discourages investment abroad and protects that in the United States.

B. Iowa Tax Treatment Of Subsidiary Dividends Is Justified By Valid Factors Not Related To Economic Protectionism.

In *New Energy Company of Indiana v. Limbach*, 486 U.S. 269, 274 (1988), the Supreme Court stated:

> Thus, state statutes that clearly discriminate against interstate commerce are routinely struck down . . . unless the discrimination is demonstrably justified by a valid factor unrelated to economic protectionism. . . .

(Continued from previous page)

part of such tax base, a domestic subsidiary's earnings are taxed by the United States Government and the forty-six states and the District of Columbia which impose taxes on net incomes. J. Hellerstein, *State Taxation: Corporate Income and Franchise Taxes* ¶1.6, at 20-21(1983). A domestic subsidiary's earnings will be subject to state income tax, whereas if the subsidiary is incorporated abroad, such income may not be subject to state tax. The Iowa tax system does not discourage the incorporation of foreign subsidiaries to conduct business outside of the United States. And, in light of the tax credit that Kraft received on its federal taxes with respect to foreign subsidiary dividends, there is no logical reason why Iowa also has to grant such a tax credit. *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, 191 n. 30 (1983).

The difference in Iowa's treatment of foreign subsidiary dividends and of domestic subsidiary dividends is a byproduct of Iowa's decision in Iowa Code § 422.35 to use the taxable income figure reported on the federal income tax return as the starting point for computation of net income for Iowa income tax purposes. *See* Iowa Code § 422.35 (App. 32a, Petition for Writ of Certiorari). Using the federal taxable income figure allows the taxpayer "to merely lift the figures off the federal return and transfer them to the Iowa [income] tax return. The Department of Revenue receives the benefit of the regulations and interpretations of the federal agency." *First National Bank of Ottumwa v. Bair*, 252 N.W.2d 723, 726 (Iowa 1977). The use of the federal taxable income figure avoids carrying out "complex procedures in computing the Iowa tax, involving the time and expense required to complete federal returns" by taxpayers. *Id.* The coupling of Iowa net income in § 422.35 with federal taxable income "is done for the convenience of the taxpayer, as a savings to the State, and to provide the State with a means of verifying the accuracy and honesty of a taxpayer's return." *Getty Oil Co. v. Taxation & Rev. Dept.*, 93 N.M. 589, 592, 603 P.2d 328, 331 (Ct. App. 1979).

Iowa's use of federal taxable income benefits taxpayers, and the State benefits in the administration of the corporate income tax by taking advantage of the federal administration of the federal income tax system as well as the taxable income concept in the Internal Revenue Code. The State accepts Internal Revenue Code exemptions and deductions, even when it means less tax will be paid to Iowa. The State has not adopted the federal taxable income concept in order to be protectionist. Iowa does

not grant a tax break for unitary business activities performed in Iowa. Thus, because the Iowa tax structure is "justified by a valid factor unrelated to economic protectionism," it does not violate the Commerce Clause. *New Energy Company*, 486 U.S. 269, 274 (1988).

II. IOWA'S TREATMENT OF DIVIDENDS DOES NOT DENY PETITIONER EQUAL PROTECTION BECAUSE IT IS RATIONALLY RELATED TO LEGITIMATE STATE PURPOSES.

Kraft's equal protection analysis is in two parts. First, Kraft erroneously states that no legitimate purpose is served by Iowa's coupling of a net income base to the federal net income base. Second, Kraft concedes that such legitimate purpose may exist, but erroneously states that Iowa has deviated so much from federal conformity that a legitimate purpose can no longer be found.

This Court has articulated various fundamental principles that govern constitutional challenges under the Equal Protection Clause. Where, as here, the challenged tax classification does not adversely affect a fundamental interest and is not based on a suspect criterion, it is only tested under the lenient standard of rationality that is traditionally applied in evaluating equal protection challenges to regulation of economic and commercial matters. *Exxon Corporation v. Eagerton*, 462 U.S. 176, 195 (1983). Under this standard, a statute will be upheld if the legislature could have reasonably found "that the challenged classification would promote a legitimate state purpose." *Id.* Broad discretion exists in creating tax classifications. *Leathers v. Medlock*, 111 S.Ct. 1438, 1446 (1991); *Madden v. Kentucky*, 309 U.S. 83, 87-88 (1940). One who attacks a

legislative classification must "negative every conceivable basis which might support it." *Madden*, 309 U.S. at 88.

A. Legitimate State Purposes Are Served.

The federal government has opted to include dividends declared by foreign corporations in the domestic corporate parent's tax base and to provide a tax credit to alleviate dual taxation by the foreign and federal governments and, also, to encourage domestic corporations' foreign business. *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 7, 9 (1932). This federal policy is not prompted by constitutional concerns, because dual or double taxation is not forbidden. *F. T. Smith Lumber Co. v. Arkansas*, 251 U.S. 532, 533 (1920). The federal government decided to grant domestic corporations a deduction for dividends paid by other domestic corporations who are subject to federal income taxation. That identical deduction was not available to individual shareholders even though such individuals could claim a tax credit with respect to their receipt of foreign corporate dividends. There is no suggestion by Kraft that the federal treatment of dividends to individual shareholders somehow violated equal protection under the Fifth Amendment.

Whether Iowa's coupling of its tax base to federal taxable income lacks a focus on dual taxation is no basis to assert that such coupling does not serve legitimate state purposes. (Kraft Pet. at 18-19). The Iowa Supreme Court properly noted the following legitimate state purposes served by that coupling:

> The coupling of Iowa net income with the federal formula is convenient for the taxpayer, prevents the taxpayer from spending time and money on complex forms, provides a saving to the state, allows the state to rely on federal regulation and interpretation, and provides the state with an inexpensive and quick way of verifying the accuracy of taxpayers' returns.[4]

Contrary to Kraft's contention, the avoidance of administrative difficulties and of expenses that taxpayers and tax administrators would otherwise experience can be legitimate state purposes.[5] *Madden*, 309 U.S. at 86-90; *Carmichael v. Southern Coal & Coke Co.*, 301 U.S. 495, 511

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[4] "The outstanding characteristic of State corporate net income measures is their broad conformity to the measure of the Federal corporation income tax." J. Hellerstein, *State Taxation: Corporate Income and Franchise Taxes* ¶7.2, at 266 (1983).

[5] Kraft states that these considerations can never be used as a justification for a coupling result that would have the effect of taxing interest and dividends from federal securities in light of the doctrine of intergovernmental immunity. (Kraft Pet. at 21, n. 14). But, this Court has held that when the issue is intergovernmental immunity, "it is inappropriate to rely solely on the mode of analysis developed in our equal protection cases." *Davis v. Michigan Department of Treasury*, 489 U.S. 803, 816 (1989). Kraft also states that Iowa could not tax Illinois corporations solely on the basis of income calculated under Illinois law. (Kraft Pet. at 20-21). But, it is obvious that if Iowa based its tax on the Illinois tax law solely for Illinois corporations, it would be engaged in the very "invidious discrimination, the wholly arbitrary act" which violates equal protection guarantees. *New Orleans v. Dukes*, 427 U.S. 297, 303-04 (1976). The Iowa tax system, under attack here, has no analog to such an extreme example posited by Kraft. The federal taxable income concept is based upon statutes and regulations uniformly applicable to all similarly situated corporations.

(1937). Taxation of income of corporations involves complex determinations and calculations of gross income and deductions, as a cursory reading of the Internal Revenue Code and Internal Revenue Service rules would suggest. In addition, the proper accounting principles must be used. Of the array of complicated accounting systems that can be employed, the tax agency must carefully limit the diversity of accounting systems "to ensure as far as possible that similarly situated taxpayers pay the same tax." *Thor Power Tool Co. v. Commissioner of Internal Revenue*, 439 U.S. 522, 544 (1979).

Federal tax treatment of corporate distributions, including dividends, is "a wonderfully complex subject." Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶7.01, at 7-2 (4th ed. 1979). A host of complicated determinations with respect to dividends and corporate distributions exist. *Id.* at ch. 7. By coupling Iowa net income determinations with the federal taxable income concept, Iowa and taxpayers need apply only one set of rules. In addition, acrimony between taxpayers and tax agency as to the make-up of the tax base is significantly reduced in that determinations made at the federal level will not be subject to decision anew nor be in conflict with those at the state level.

States have no real practicable alternative to application, at the state level, of a host of Internal Revenue Code statutes, Internal Revenue Service regulations, and Internal Revenue Service audit results in making the necessary determinations inherent in a calculation of taxable income because "[s]tate tax administrators have neither large enough staffs nor sufficient expertise to perform full-scale independent audits of the books and records of

large corporations." J. Hellerstein, *State Taxation: Corporate Income and Franchise Taxes* ¶7.2[5], at 275 (1983). Iowa's tax treatment of dividends is clearly consistent with the legitimate purposes advanced by the Iowa Supreme Court. Kraft cannot negative all conceivable bases in support of the Iowa tax system. The fact that overall federal tax policy, as respects the foreign tax credit, differs from the Iowa tax policy does not detract from the legitimacy of the latter.

B. Iowa's Specific Adjustments To Federal Taxable Income Are Not Inconsistent With The Legitimate Purposes Of Federal Conformity.

Kraft points to nine adjustments in Iowa Code sec. 422.35 (1983) that it claims undermine the legitimate state purposes found by the Iowa Supreme Court to be inherent in Iowa's federal taxable income conformity. (Kraft Pet. at 21-22). Kraft's position lacks merit. There is no rigid rule that requires a state to adopt, without modification, the entire federal tax system.[6] As Professor Hellerstein observes, "[t]he most efficient and simplest method of achieving Federal conformity, without complete piggybacking, is to incorporate by reference in the State statute the current key Federal income tax terms, such as 'gross income' and 'taxable income' and then make such specific adjustments as State policy may dictate." J. Hellerstein,

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[6] Merely because Congress has elected a policy with respect to income at the federal level does not "mandate identical treatment by the States." *Mobil Oil Corp. v. Commissioner*, 445 U.S. 425, 448 (1980).

supra p. 22, ¶7.2[1], at 267. Iowa has adopted this approach. *Id.* at 267 n. 19.

Under the logic of Kraft's reasoning, there can never be justification for coupling of state taxable income to federal taxable income to accomplish a legitimate state purpose if the state has enacted a few adjustments to the federal taxation income concept. Kraft does not cite to any authority in support of its novel and unjustified position. Neither the qualitative nor the quantitative nature of Iowa's adjustments require a Court to reject the overall coupling results (or any part of them) on the grounds that they somehow are no longer rationally related to otherwise legitimate state purposes. Within the context of the Iowa law that provides for very few adjustments to federal taxable income in comparison to the multitude of coupling determinations and calculations, it is absurd to suggest that the Iowa tax system has only a remote relationship to federal taxable income. Kraft has not negated the legitimate state purposes that inure to taxpayers and to Iowa as a result of Iowa's incorporation of massive and complex determinations and calculations, including those involving dividends, at the federal level into its income tax system.

Kraft's contention runs afoul of this Court's pronouncement that consistent with equal protection, the legislature may partially, rather than wholly, eliminate all sources of a problem. *Minnesota v. Clover Leaf Creamery Company*, 449 U.S. 456, 466 (1981). Iowa's method and extent of conforming the tax base to federal taxable income are consistent with the legitimate state purposes enumerated by the Iowa Supreme Court.

CONCLUSION

For the above-stated reasons, the Department respectfully requests that the Petition for a Writ of Certiorari be denied.

Respectfully submitted,

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